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Japan: The Economy and the Elections

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An Intelligence Assessment

State Dept. review completed

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EA 83-10102
June 1983

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Japan: The Economy and the Elections

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An Intelligence Assessment

This paper was prepared by Office of East Asian Analysis. It was coordinated with the National Intelligence Council.

Comments and queries are welcome and may be directed to the Chief, Japan Branch, OEA, on

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Japan: The Economy and the Elections

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Key Judgments

Information available as of 27 May 1983 was used in this report.

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Japan will be on the path toward—but not yet enjoying—economic recovery when Upper House elections are held on 26 June. Leading indicators this year are mixed, and most officials in Tokyo are reluctant to declare the two-year-long recession over. Even those officials confident the economy has turned the corner have warned that recovery will be moderate. We believe Japan's economy will do well to match the 3.5-percent growth of fiscal year 1982, which ended on 31 March. With slow domestic growth holding down import demand, we expect the Japanese current account surplus to reach $24 billion in calendar year 1983.

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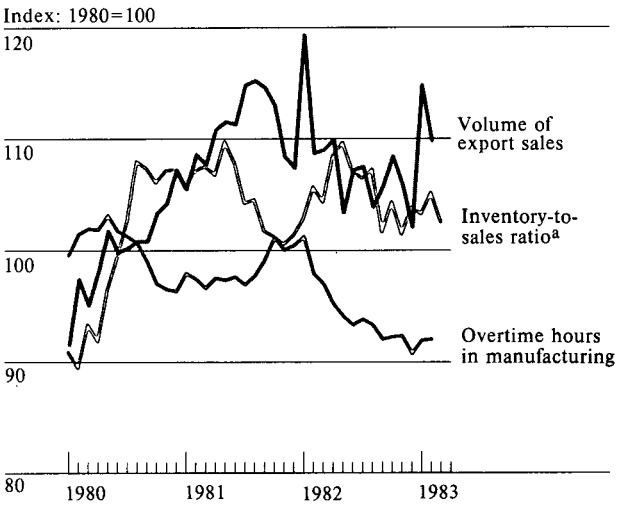
Figure 1
Japan: Economic Indicators



[a] Reverse cycle, so lower numbers indicate improvement.

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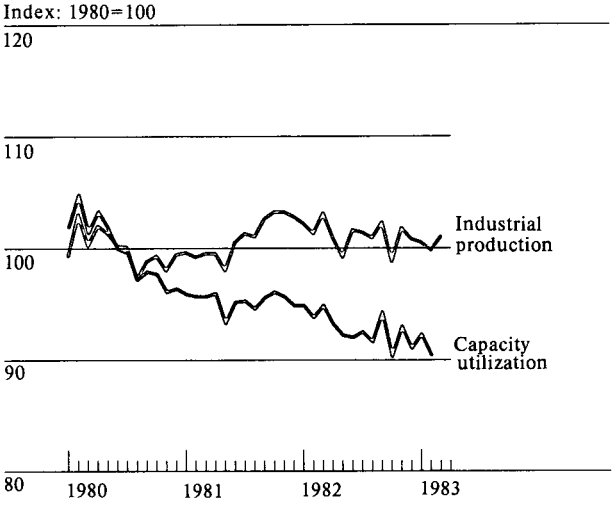
Figure 2
Japan: Business Indicators



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Introduction

Domestic policy choices, a poor investment climate, and voluntary restraints on exports will prevent Japan's economy from staging a strong recovery this year. The Japanese economy initially looked like it would rebound quickly after the oil price hikes of 1979 and 1980, but the promising signs disappeared rapidly:

- In late 1979 the growth of government spending began to decelerate as the Ohira administration embarked on a "fiscal reconstruction" campaign to curtail the government deficit.
- With industrial production lagging, labor had to swallow real wage cuts, and private consumption weakened.
- By the time consumption revived in 1982, declining world trade and rising protectionism had crippled export performance—the previous mainstay of growth.
- Large manufacturing firms also scaled back investment plans, further dampening economic growth.

The decline in exports, however, did not prevent an improvement in the current account in 1982. The surplus rose from $4.8 billion in 1981 to $7.6 billion, in part because higher interest rates abroad boosted investment income. Imports declined as firms drew down raw material inventories accumulated in 1980 when forecasters were optimistic about growth prospects.

Signs of Recovery Prove Elusive

So far, the indicators have not given a clear view of whether economic growth is being rekindled. Japan's Economic Planning Agency's (EPA) index of leading indicators has shown no clear pattern since January (see figures 1 and 2). Individual components of the series also show a mixed economic picture:

- New orders for machinery and construction remain well below year-earlier levels.
- The ratio of producers' inventories to shipments has declined from the peak reached in May 1982 but still remains above 1980 levels.
- One positive sign is that the index of hours of overtime worked in the manufacturing sector registered moderate increases in the first two months of the year.

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Bank of Japan, focusing on a recent pickup in exports and on the progress made in inventory adjustment, is 25X1 more confident that the worst is over and recovery is at hand.

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Policy Constraints

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Japanese officials cite several obstacles blocking efforts to hasten the recovery. Bank of Japan officials have been reluctant to cut the discount rate, because such a move might lead to a resurgence of long-term capital outflows. The 13-percent depreciation of the yen against the dollar last year was partially the result of the wide disparity in Japanese and US interest rates, which in turn led to a net outflow of $15 billion in long-term capital.

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Fiscal stimulus also has been ruled out because 25X1 Japanese bureaucrats and businessmen are uneasy over the rapid growth of the government deficit during the last decade and have qualms about mounting refinancing needs.[1] General account expenditures

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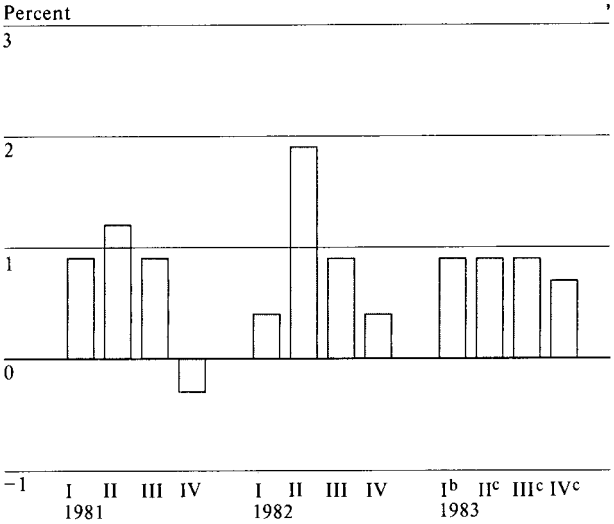
Figure 3
Japan: Changes in GNP[a]



[a] Measured in 1975 prices. Change from previous quarter.
[b] Estimated.
[c] Projection.

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by the central government in FY 1983 are budgeted to be only 6 percent above the austere FY 1982 spending levels.

Liberal Democratic Party (LDP) politicians continue to be responsive to pressure from backers in the business community, who want the deficit trimming to proceed.

Pessimistic Forecasts Abound

We are bearish about the short-term growth prospects for the Japanese economy (see figure 3). Our forecast of 3.4-percent real GNP growth for FY 1983 matches the official Japanese projection. Like theirs, our forecast assumes that government investment spending will be concentrated in the first half of the year, and that the discount rate will be lowered; we have also assumed a 0.5-percentage-point cut in midsummer. Even with these assumptions, the FY 1983 growth rate will be little changed from the 3.5-percent rate that we estimate occurred in FY 1982.

The US Embassy in Tokyo, forecasting on a calendar year basis, also believes year-to-year growth will change little.[2]

[2] Our forecast for real GNP growth on a calendar year basis is 3.7 percent, 0.5 percentage point higher than the Embassy forecast. Our calendar year forecast exceeds our fiscal year projection because government investment will be concentrated in April-September. Frontloading government spending is a standard practice in Japan.

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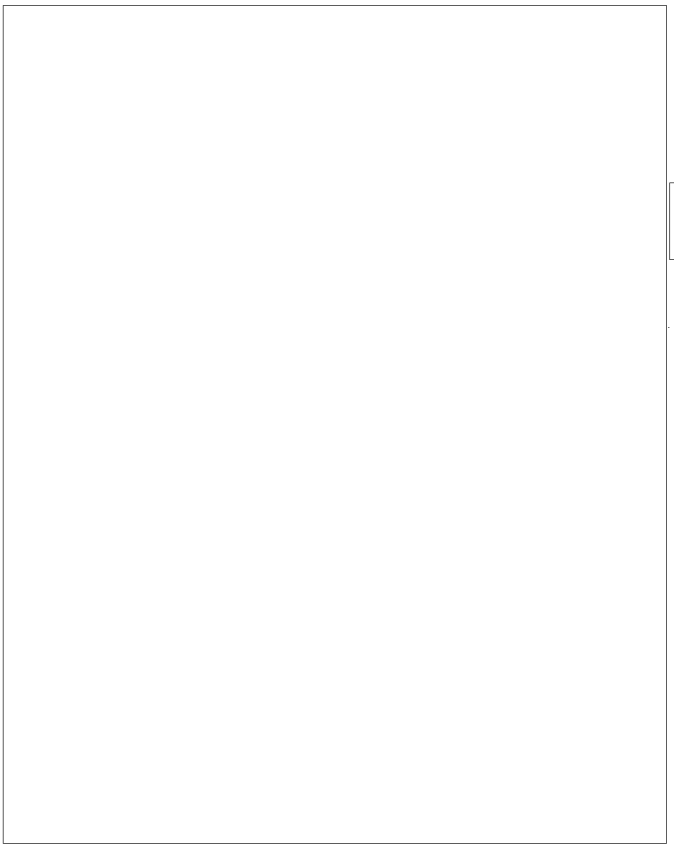

Prospects for Private Sector Mixed

On the positive side, lower energy prices than in 1982 and the economic recovery in the United States will benefit Japan this year. The drop in oil prices will reduce Japan's import bill by an estimated $7-8 billion. However, Ministry of International Trade and Industry (MITI) bureaucrats remain reluctant to pass these savings along to industry and households in the form of lower utility rates. Instead, they want to allow public utilities to capture—at least temporarily—the windfall profits. The utilities suffered large losses last year because of the yen's depreciation.

Negative developments in the private sector seem to outweigh positive ones. The recent record-low wage settlements, although a positive development as far as prices are concerned, will hold down personal consumption. Businessmen, aware of constraints on domestic growth and concerned by rising protectionism, are wary of investing in plant and equipment. Surveys of anticipated capital spending, conducted by a variety of banks and government agencies, are uniformly pessimistic. If businesses stick to their plans, FY 1983 growth in private investment will be the lowest in six years.

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Current Account Uncertainties

For all forecasters, the current account proved the most difficult item to predict last year for Japan; the same will likely be true for CY 1983. In 1982 overly optimistic assumptions about the growth of world import volume led to estimates well above Japan's actual surplus of $7.6 billion:

- Our forecast made in January 1982 assumed 4.5-percent world import growth (excluding Japan) and predicted a $18.5 billion surplus—$11 billion above the actual outcome. Measured in 1975 dollars, world trade increased only 1.5 percent last year.

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- An OECD forecast made at the same time and positing 3-percent world import growth predicted a $14.5 billion surplus.

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Our projection of a $23.5 billion current account surplus in 1983 assumes 2.4-percent world import volume growth. If trade picks up more rapidly than we have assumed—say by an additional percentage point—Japan's current account surplus could approach $27 billion. In our forecast we have assumed a moderate appreciation of the yen, especially in the second half of 1983. Our best guess is that the yen will end the year around 220 to the dollar, reflecting the increase in the current account surplus and some decline in capital outflows because of lower US interest rates. In recent months the yen has been trading at 230 to 240 to the dollar. Even with this appreciation, however, the yen would still be below its

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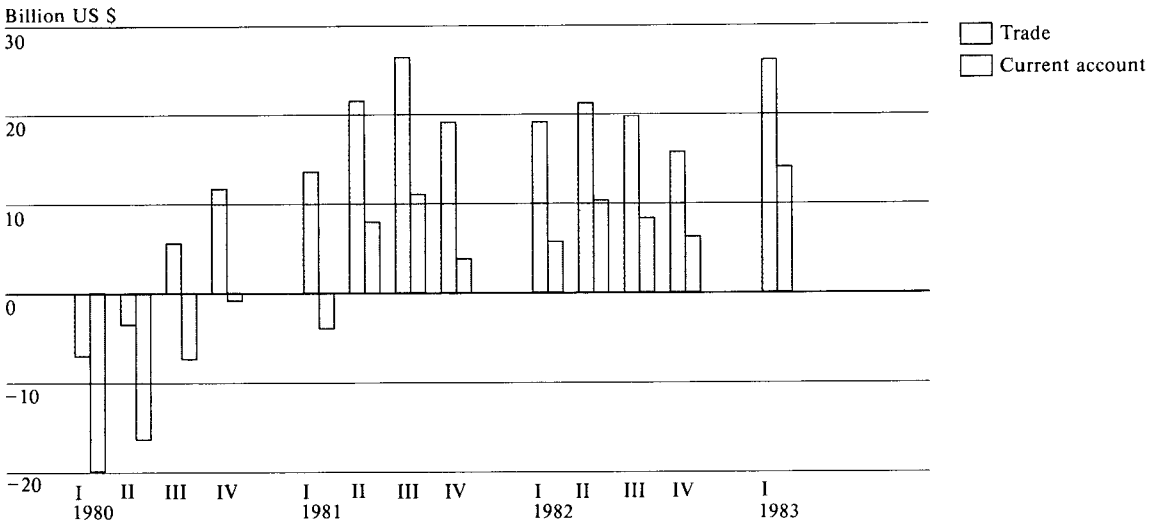
Figure 4
Japan: Trade and Current Account Balances[a]



[a] Seasonally adjusted and annualized.

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1981 level on a trade-weighted, price-adjusted basis. The continued weakness of the yen will put Japanese firms in a good position to garner an increasing share of world exports.

The existence of numerous export restraints, however, raises an alternative risk—that our current account forecast is too high. Estimates of the share of Japanese exports affected by restrictions range from 15 percent to 65 percent of the total. However, it is not clear that restrictions significantly alter the dollar volume of sales. In cases where restrictions limit export volume, such as auto shipments to the United States, Japanese firms are raising unit prices.

Another downside risk concerns raw material import prices. If these prices increase by 5 percent this year instead of declining slightly as we have assumed in our baseline case, the surplus will fall approximately $2 billion.

Although the size of the current account surplus this year is debatable, it is certain that it will exceed the 1982 level. Indeed, through April 1983, the surplus was running at an annual rate of $17.4 billion. Other major forecasters—including the US Treasury, and the OECD—expect a current account surplus between $14.5 billion and $19.4 billion. The difference between these estimates and our forecast reflects in part our assumption of a 9-percent yen appreciation between now and the end of the year. This appreciation would increase the dollar value of yen export receipts.

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The Economy as a Political Issue

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Although Japan's mushrooming current account surplus captures the attention of foreigners, it is the so-so growth prospects that matter most to the Japanese public. Nonetheless, we believe economic issues will

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have only a minimal impact on the outcome of the 26 June Upper House elections. . Moreover, at this point, few voters blame Nakasone for the drab economic performance of the last two years. In a poll conducted by *Asahi Shimbun* in May, only 14 percent of those critical of Nakasone cited his economic policies as the principal reason.

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The lack of a close correlation between the economy and the fate of the incumbents does not mean that the LDP—which currently holds about half of the 126 seats at stake—will do well. Nakasone's decision to forgo simultaneous Lower and Upper House elections is expected to depress voter turnout. Traditionally, the LDP does best when turnout is high. Secondly, a few observers believe recent changes in the Upper House election laws—involving introduction of proportional representation in national constituencies—may harm the LDP.

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Lower House Elections in the Fall?

The LDP showing in the June elections will be one factor in Nakasone's decision on whether to press for Lower House elections in the autumn, well before the June 1984 deadline.

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Even if Nakasone decides against early general elections, he may be forced to pursue a more expansionary fiscal policy. To win approval of the FY 1983 budget, the LDP promised to consider a personal income tax cut later this year. Bureaucrats in the Ministry of Finance insist the resulting revenue shortfall will have to be made up through an increase in indirect taxes. But the Socialists and the labor unions continue to push for a unilateral tax cut. If he sides with the bureaucrats, we believe Nakasone has the clout to hold the tax cut proponents at bay. A good LDP showing in June, we believe, would bolster Nakasone's resolve to stick with his conservative, no fiscal stimulus policies.

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Even if fiscal policy stimulus is undertaken, we believe it would not add significantly to Japanese growth. A spending increase of 500 billion yen ($2 billion) in the second half of the fiscal year would, according to our calculations, add only 0.2 percentage point to the real growth rate.

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we estimate that the current account surplus would be only $300 million below our original forecast. If Tokyo opts to cut personal income taxes by this amount rather than boost spending, the impact is even smaller because of the high propensity to save out of windfall income. We estimate that 75 percent of a tax cut would be saved, permitting less than a 0.1-percentage-point gain in real GNP growth.

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